

INVESTMENT ADVISORY COUNCIL

Wednesday, February 9, 2011

**SUCH MINUTES ARE IN DRAFT FORM AND SUBJECT TO THE FINAL REVIEW
AND APPROVAL OF THE INVESTMENT ADVISORY COUNCIL.**

MEETING NO. 382

Members present:

Thomas Barnes
Michael Freeman**
David (Duke) Himmelreich
Stanley (Bud) Morten
William Murray*
Denise L. Nappier, Treasurer
David Roth
Joseph (Joe) D. Roxe, Chairman
Carol Thomas*
Peter Thor

Absent:

Thomas Fiore, representing Benjamin Barnes
Sharon Palmer

Others present:

Lawrence (Larry) Wilson, Interim Deputy Treasurer
M. Timothy (Tim) Corbett, Chief Investment Officer
Lee Ann Palladino, Deputy Chief Investment Officer
Wayne Hypolite, Executive Assistant
Donald Kirshbaum, Investment Officer - Policy
Catherine LaMarr, General Counsel
Shelagh McClure, Director of Compliance
Christine Shaw, Interim Assistant Deputy Treasurer
Linda Tudan, Executive Assistant
Winifred (Winnie) Scalora, Administrative Assistant

Guests:

Joseph Barcic, Mercer Investment Consulting
Vonda Brunsting, Service Employees International Union
Andre Collin, Lone Star Funds
Sean Gill, NEPC, LLC
John Grayken, Lone Star Funds
Will Greene, Loop Capital Markets
Harvey Kelly, Leumas Advisors
Alan Kosan, Rogerscasey, Inc.
Louis Laccavole, SOC Teachers' Retirement Board
Tania Naaman, BNY Mellon Asset Management
Kevin Norton, BNY Mellon Asset Management
Johnson Shum, State Street Bank & Trust
Chris Smith, Service Employees International Union
Nick Stanojev, BNY Mellon Asset Management

* In at 9:06 a.m.

** In at 9:09 a.m.

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2

Michael Stark, The Townsend Group
Robert Steyer, Pensions and Investments

With a quorum present, Chairman Joseph Roxe called the Investment Advisory Council ("IAC") meeting to order at 9:00 a.m.

Approval of Minutes of the December 8, 2010 IAC Meeting

Chairman Roxe asked for comments on the Minutes of the December 8, 2010 IAC meeting. **There being no comments, a motion was made by Stanley Morten, seconded by David Roth, that the Minutes of the December 8, 2010 IAC meeting be accepted as drafted. The motion was passed unanimously.**

Chief Investment Officer's Update on the Market, CRPTF Final Performance for the Months Ended November 30, 2010 and December 31, 2010, and Issues for Review and Discussion in 2011

M. Timothy Corbett, Chief Investment Officer, provided an update on the capital market environment, its impact on the performance of the Connecticut Retirement Plans and Trust Funds ("CRPTF") and the economic outlook. He first commented on three major market moving events: 1) Federal Reserve Chairman Ben Bernanke's second round of quantitative easing; 2) the European sovereign debt crisis and the inflation concerns associated with emerging markets; and 3) the United States tax extension agreement. Mr. Corbett concluded that the longer term outlook is expected to remain cloudy due to the unacceptably high level of unemployment and the Federal and state fiscal deficits.

Mr. Corbett reported on the performance of the CRPTF for the months ended November 30 and December 31, 2010. He stated that the Combined Investment Funds ("CIF") had increased over 4% for the month ended December 31, 2010, and that pension fund assets increased by \$600 million to \$24.5 billion since October 31, 2010. Mr. Corbett reported that the CIF's performance as of December 31, 2010 increased 12.55% and 14.91% for Fiscal Year ("FY") 2011 and the 2010 calendar year, respectively; and brought three-year total returns back to positive territory. Regarding benchmark-relative performance, he reported that the Teachers' Retirement Fund ("TERF") outperformed for the 2010 calendar year, three-, five-, and seven-year periods; the State Employees' Retirement Fund ("SERF") outperformed for the 2010 calendar year and three-year period; and the Municipal Employees' Retirement Fund slightly underperformed for the 2010 calendar year and over the longer-term periods. With respect to fund performance, Mr. Corbett reported strong positive returns for public equity markets, which increased about 7% for the month ended December 31, 2010 and had double digit returns for the 2010 calendar year, and he reported that five of the eight public markets outperformed their benchmarks in December 2010, for the trailing quarter, FY 2011 and the 2010 calendar year.

Regarding the asset allocation for TERF and SERF, Mr. Corbett stated that all of the funds were within their policy ranges as of December 31, 2010, with the exception of the Real Estate Fund ("REF"), which was slightly below the range. He stated that funding had begun for the

Alternative Investment Fund's ("AIF") hedge fund-of-funds portfolio. Mr. Corbett added that funding for this allocation to the AIF was derived from reduced allocations to the Emerging Market Debt Fund, Mutual Equity Fund ("MEF") and Developed Markets International Fund ("DMISF"). He then reminded the IAC that the target allocation to the AIF is to be funded by reduced targets to the MEF, DMISF, Core Fixed Income Fund and Inflation Linked Bond Fund. In response to Mr. Roth, Mr. Corbett stated that quarterly in-depth reviews of the AIF portfolio would be presented to the IAC.

Discussion ensued about what information would be disclosed to the IAC. Mr. Corbett reinforced that the CRPTF had complete transparency from a risk aggregation perspective in the underlying AIF funds. Chairman Roxe commented about expected inflation and the importance of being positioned ahead of the curve. Mr. Corbett agreed and noted that consensus forecasts for interest rates were projected to rise by the end of the 2011 calendar year. Chairman Roxe posed questions about the manner in which cash was reported in the Liquidity Fund ("LF"). He questioned whether it was appropriate to include cash held by investment managers in the LF since it was thereby counted twice and overstated the total assets in the CRPTF and overstates the financial flexibility provided by the LF. In response to Chairman Roxe, Mr. Corbett stated that he would present an update of the LF at an upcoming IAC meeting to clarify the discussion points raised.

Mr. Corbett then commented on recent foreign exchange currency transactions lawsuits with custodian banks, updated the IAC on the CRPTF's review and analysis of the contract with its custodian bank, State Street Bank & Trust ("State Street"), and the conclusion that the CRPTF is receiving the benefit of its contractual bargain with State Street. He added that this would be an area of focus during the upcoming custodian search.

In response to a request by Chairman Roxe, Mr. Corbett discussed upcoming searches and other areas of focus that would likely be presented to the IAC during 2011. Chairman Roxe said that the general investment consultant search was the critical item from which the 2011 workflow would be paced. A draft summary of the schedule for 2011 is attached.

Comments by the Treasurer

Treasurer Nappier commented on the growing number of articles concerning the sustainability of government-sponsored defined benefit pension plans. She noted that she has brought attention to this issue over the past ten years, but only since the unprecedented market downturn has there been such a high level of media attention paid to the issue of unfunded liabilities. She expressed concern over recent articles that have exaggerated the ill health of defined benefit plans.

Treasurer Nappier noted that she had asked the Connecticut General Assembly to raise two bills that would: 1) create a seat for the Treasurer as an *ex officio* member on the governing boards of SERF and TERF, so that there could be better coordination of policies affecting both assets and liabilities; and 2) require an actuarial cost estimate of any proposed pension benefit changes before the Connecticut General Assembly could enact such changes. She noted that this requirement was not in place at the time that prior retirement incentives were offered.

Treasurer Nappier commented on a recent report by Moody's Investors Service concerning the recent expansion of its methodology for evaluating states' creditworthiness to include unfunded pension liabilities. She noted that Governor Rell had convened a blue ribbon commission to study pension issues, and that the commission issued a report offering recommended options that would address the unfunded liability. She shared her expectation that the State would attempt to make some changes to its defined benefit plan. Treasurer Nappier ended by noting that the upcoming asset/liability and asset allocation study must take into account the likelihood of changes to the State's pension plans.

Treasurer Nappier then announced staff changes within the OTT. She introduced Lawrence ("Larry") Wilson as Interim Deputy Treasurer and noted that he presently served as Assistant Treasurer of the Cash Management Division. Treasurer Nappier noted the depth of her staff, as she called upon Larry's 19 years of service with the Treasury and his extensive background working with the Office of Policy and Management. She also asked Christine Shaw, Director of Government Relations, to take on the role of Interim Assistant Deputy Treasurer. Finally, Treasurer Nappier announced her appointment of Donald Kirshbaum, Investment Officer, with his extensive knowledge about the State's fiscal affairs, as Interim Director of Policy. She added that the service and experience of Mr. Wilson, Ms. Shaw and Mr. Kirshbaum would provide continuity during this transition period until permanent replacements were announced.

After considering the feedback from the IAC and the due diligence process led by Mr. Corbett, which included input from the real estate investment consultant, Treasurer Nappier stated that she had made a final decision to commit \$75 million to Blackstone Real Estate Special Situation Fund II ("BSSF II"), a real estate investment value-add opportunity, and that contracts were successfully negotiated on January 31, 2011. She added that the primary focus of this fund was on capital preservation and the distribution of current income on a quarterly basis.

Treasurer Nappier then stated that the proposed project plan for the master custodian search consultant, which included the required screening and selection criteria for the competitive search, would be presented today. She said that this request for proposal ("RFP") was being issued for a consultant to assist the OTT with its master custodian search. Treasurer Nappier added that the consultant would accomplish a number of tasks including updating the needs analysis and the competitive RFP for a master custodian and that the OTT seeks to hire a consultant with deep global experience and extensive insight into the master custodian universe.

Treasurer Nappier stated that discussion would also continue on the longer-term historical and projected cash flows for SERF and TERF. She then said that the amount of cash flow associated with contributions and dividend and income were insufficient to meet the requirements for pension fund benefits; therefore, once again it was likely that core assets would have to be sold to meet the cash flow demands. She added that new to this year's report, the OTT's projections had been expanded from a one-year to a five-year horizon. With insight into the benefits of longer-term cash flow projections, Treasurer Nappier stated that SERF would receive higher actuarially required contributions, slower projected growth in pension benefit payments, and over time this combination would eliminate the imminent need to raise cash. Conversely for TERF, its cash

requirement profile would remain similar to how it currently stands - meaning a continued annual outflow of cash.

Consideration of the Search Process for Consulting Services for a Master Custodian

Lee Ann Palladino, Deputy Chief Investment Officer, provided a project plan timeline and evaluation/selection criteria for a master custodian consultant. Ms. Palladino stated that the CRPTF's contract with State Street, its master custodian, was due to expire in June 2011. She added that the current contract allowed a two-year extension which the CRPTF would request and utilize; and, therefore, an RFP process for the master custodian search would be utilized. Finally, she commented on the anticipated time frame to get the search completed and noted that this particular search was a lengthy process.

Chairman Roxe confirmed that today's approval was to find a consultant to help find a custodian, and he reviewed the timeline for both. He then asked for a motion to endorse the search process for a master custodian consultant. **David Himmelreich entered a motion to move forward with this search. Ms. Thomas seconded the motion. The motion was passed unanimously.**

Update on the Cash Flow Report for the Teachers' Retirement Fund and State Employees' Retirement Fund

Ms. Palladino provided an update on the cash flow report for FY 2010 and projections for FY 2011 for TERF and SERF. She began by commenting on the historical cash flow patterns from 1999 to 2011. Ms. Palladino then reviewed the FY 2011 cash flow projections for TERF and SERF. She said that she expected FY 2011 to be the trough year from a cash flow perspective for SERF, with steady improvements due to higher actuarially required contributions and slower projected growth in pension benefit payments. Regarding TERF, she stated that she expected cash outflow would remain steady over the next five years.

Ms. Palladino concluded that by FY 2015, TERF contributions are projected to grow 33%, and pension benefits to rise 22%. She stated that net cash required for TERF in 2011 was about 4.8% of total assets, and was projected to increase slightly to 5.1% by 2015. Regarding SERF, Ms. Palladino noted contributions are projected to rise 50% by 2015 and pension benefits to increase 10%. She said that net cash requirements for SERF in 2011 were 4.7% of total assets and were projected to be close to zero by 2015. Ms. Palladino reminded the IAC that these projections were also contingent on the assumptions made for interest rates and capital calls, both of which can be highly influential on cash flow positions.

Presentation by and Consideration of Lone Star Real Estate Fund II, LP

Ms. Palladino provided opening remarks and introduced Lone Star Real Estate Fund II, LP ("Lone Star II"), a distressed debt real estate investment opportunity. Michael Stark, Associate of the Townsend Group ("Townsend"), provided additional remarks. Ms. Palladino first provided a review of the strategic fit and noted that potentially up to \$500 million would be invested in the distressed real estate strategies, with current allocations of \$200 million to the Public-Private

Investment Program and \$75 million to BSSF II. Ms. Palladino stated that Lone Star Funds ("Lone Star") purchased performing and non-performing commercial loans at a substantial discount within US, European and Japanese markets. She added that Lone Star II would meet the objectives of the REF which included preserving capital, generating current income, and targeting a 20% net internal rate of return. Ms. Palladino stated that advantages of Lone Star included an exclusive focus on distressed real estate strategies throughout the world; a large scale global platform; lack of competition targeting large financial institutions; solid underwriting capabilities; a strong performance track record at or near top quartile; and the competitive advantage of a wholly-owned affiliate, Hudson Advisors, LLC. ("Hudson"), to handle asset management, administrative and other issues. Finally, she spoke about Lone Star's professional team.

Ms. Palladino and Mr. Corbett responded to several questions posed by IAC members including: Lone Star's valuation methods; the General Partner's relationship with its affiliate; Hudson; its fee structure; Lone Star's cash-on-cash returns and IRRs; and the drivers of performance.

Presentation by Lone Star Funds

Lone Star made a presentation to the IAC on its real estate investment opportunity. Lone Star was represented by Andre Collin, Director - Origination Activities of Distressed Commercial Real Estate Debt Products and Equity in North America, and John Grayken, Founder and Managing Partner. Mr. Grayken began by providing an overview of Lone Star and noted that he founded Lone Star in 1995 for the purpose of organizing and investing institutional capital in distressed commercial mortgage debt. He commented on the US commercial real estate market's collapse in the mid-1990's and the opportunities it presented, and he said that Lone Star's investment strategy is to move to markets throughout the world where the supply/demand of real estate was markedly out of balance. Mr. Grayken then provided a description of Lone Star II, including its target fund size, investment strategy, expected investment capital allocation, target investment returns and investment period. He next commented on the current US, European and Japanese investment environments, noting that the US current supply was high relative to demand, with light competition and low prices. Finally, Mr. Grayken stated that he expected that the current investment environment would allow Lone Star II to achieve a 25% gross IRR, which should net investors between 18% and 20%.

Mr. Roth posed questions about Lone Star's general strategy, how it chose its target markets, length of fund-raising time, leverage, securities versus whole loans, and Lone Star's relationship with Hudson. Mr. Grayken commented on the difficulty of raising funds within the current economic market, but noted that this was actually an advantage because there would be less competition. Mr. Grayken then detailed Lone Star's investment strategy and why it was a whole loan investor. Regarding Hudson, Mr. Grayken stated that Hudson Advisors was Lone Star's servicer, completely dedicated to the interests of the General Partner; and with regard to conflicts and fee arrangements for Hudson, he stated that the limited partner advisory committees had voting power to determine the fees and conflict resolution, not the General Partner. In response to Mr. Morten's questions on performance numbers, Mr. Grayken stated that while the average life span of the funds was five years or less, including those funds with residual assets, individual investments were typically outstanding for about two years. Messrs. Grayken and Collin then

provided details on Lone Star's individual funds in response to Mr. Morten's questions. Mr. Grayken also stated that Lone Star was not a currency trader or speculator and its policy was to be currency neutral and it hedged its currency risk. Regarding Mr. Thor's question about Lone Star's key man clause, Mr. Grayken stated that there was a strong, long-standing team at Lone Star that could handle the business, but added that the key man provision allowed investors to opt out of further capital calls. With respect to opportunity, Chairman Roxe commented that the large distressed commercial real estate debt would probably peak in 2013; but banks were currently extending maturities on loans to avoid taking large losses, which would be realized if they foreclosed on or sold troubled loans. Mr. Grayken explained why there was a lag between when a crisis hits and when the banks sell the debt, and he noted that the banks were just beginning to write down the losses. He spoke about Lone Star's global niche and noted that its strategy was to purchase portfolios, not single assets like most investors.

Roll Call of Reactions for Lone Star Real Estate Fund II, LP

Chairman Roxe requested the IAC members to provide input on Lone Star Real Estate Fund II, LP. Thomas Barnes commented on his prior experience as a trustee with a municipality that invested in Lone Star and said that he was impressed with the Fund. Michael Freeman, William Murray, Messrs. Barnes, Himmelreich, Thor and Roth, Ms. Thomas and Chairman Roxe were all in favor of the investment. Mr. Morten said it was a close call but he was not in favor of the investment. Mr. Roth added that he liked the distressed real estate space and the returns were on target. Ms. Thomas added that a quick turnaround would be beneficial to the CRPTF's cash flow. Chairman Roxe added that distressed commercial real estate had great potential if properly invested, Lone Star had demonstrated its ability to succeed in this quick buy-side strategy, and the timing was right.

Chairman Roxe asked for a motion to waive the 45-day comment period for Lone Star Real Estate Fund II, LP. **A motion was made by Mr. Himmelreich, seconded by Ms. Thomas, to waive the 45-day comment period for Lone Star Real Estate Fund II, LP. Mr. Morten noted that he could not be in favor since he was not in favor of the investment. The motion was passed by majority.**

Securities Lending Review as of December 31, 2010

Johnson Shum, Vice President of State Street Bank, provided a review of securities lending activity for the period of July 1 through December 31, 2010. Mr. Shum first provided an earnings and performance review and noted that during FY 2010 CRPTF's total funds earned \$15.7 million with return on lendables at 11.37 basis points ("bps"). He reported that earnings for the first half of FY 2011 were comparable to what was averaged for the entire FY 2010. Mr. Shum then reported earnings of \$13.8 million for the 2010 calendar year, which was above earnings for 2006 and just slightly below for 2007. He noted that, now that the CRPTF's statutes were changed to allow the program to add sovereign debt in 2010, non-cash collateral has increased from \$40 million to \$198 million, increasing return potential. In summary, he stated that Connecticut's collateral investment fund stood at \$3.6 billion as of November 30, 2010 and continued to be conservatively managed.

Corporate Governance and MacBride Compliance

Donald Kirshbaum, interim head of the Policy Unit, provided a report on corporate governance and MacBride compliance for the quarter ended September 30, 2010. Mr. Kirshbaum first commented on the 2011 proxy season and discussed the corporate governance issues Treasurer Nappier had identified for the 2011 proxy season which included an independent board chair, board diversity, majority voting for election of directors, political expenditure disclosure, and succession planning. Mr. Kirshbaum commented on the Dodd-Frank Act of 2010 ramifications for say-on-pay. He noted Treasurer Nappier encouraged companies and shareholders to support say-on-pay votes.

In response to Mr. Himmelreich's question about repealing or changing the state law that requires CRPTF divestment from companies that have not implemented the MacBride Principles due to the costs of complying with this mandate, Treasurer Nappier said she was not aware of grounds for having this law amended. Mr. Kirshbaum said that the expenses included the managers' subscribing to a service providing this information and that Connecticut was the only state that required mandatory divestment regarding the MacBride Principles. Mr. Himmelreich suggested that it might be time to revise the MacBride Principles statute to a format similar to that used for Sudan, which allowed more flexibility in its oversight. Mr. Kirshbaum responded to Mr. Roth's questions regarding political contributions by stating that the OTT's position is on disclosure of political contributions, in order to protect share-holder value. Mr. Kirshbaum added that many companies do disclose direct contributions to individual campaigns on their web sites.

Other Business

Chairman Roxe invited IAC members to submit agenda items for the March 9, 2011 IAC meeting.

Chairman Roxe stated that Catherine LaMarr, General Counsel would present the search process for legal counsel for Pension Fund Management ("PFM") for Consideration. Ms. LaMarr provided a project plan timeline and evaluation/selection criteria for legal counsel for PFM. She stated that contracts for a variety of different legal services were scheduled to expire in November 2011. Ms. LaMarr requested the IAC to consider the search process for a pool of counsel to assist with investment, fiduciary and bankruptcy contracts. She reminded the IAC that legal service providers were not on retainer, but were billed for services when utilized.

Chairman Roxe then asked for a motion to endorse the Search Process for Legal Counsel for PFM. **Mr. Himmelreich entered a motion to move forward with this search. Mr. Thor seconded the motion. The motion was passed unanimously.**

Chairman Roxe then led a discussion regarding indemnification of members of the IAC from litigation or any other threat. Mr. Corbett noted that there was a paragraph in Appendix I within the IAC Handbook that did address this topic. Ms. LaMarr summarized by saying that the State self-insures for liability incurred while the IAC members were engaged in public activity and the Attorney General's Office would be obligated to either defend or hire an attorney to defend them.

Comments by the Chairman

Chairman Roxe did not provide additional comments on the meeting.

Executive Session

A motion was made by Mr. Morten, seconded by Mr. Barnes, that the IAC enter into Executive Session at 1:08 p.m. for consideration of a personnel matter. The motion was passed unanimously. Treasurer Nappier, Messrs. Wilson and Corbett, Chairman Roxe, Ms. Thomas, Messrs. Barnes, Freeman, Himmelreich, Morten, Murray, and Thor participated in the Executive Session. A motion was made by Mr. Freeman, seconded by Ms. Thomas, that the IAC adjourn the Executive Session at 1:12 p.m. and enter into Regular Session. The motion was passed unanimously.

Chairman Roxe noted that no votes were taken during Executive Session.

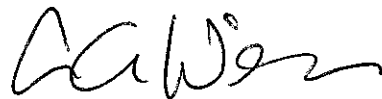
In compliance with Section 3-13a of Public Act No. 09-7, Treasurer Nappier requested the advice and consent of the IAC regarding the personnel appointments to the PFM Division made since the Public Act was approved by the legislature: Principal Investment Officer Adrian Kingshott; Investment Officer Reginald Tucker; and Executive Secretary Christina McGinnis.

Chairman Roxe asked for a motion to consent to the appointments of Principal Investment Officer Adrian Kingshott, Investment Officer Reginald Tucker and Executive Secretary Christina McGinnis. Mr. Himmelreich entered a motion to approve the appointments. Mr. Barnes seconded the motion. The motion was passed unanimously.

There being no further business, the meeting was adjourned at 1:15 p.m.

An audio tape of this meeting was recorded.

Respectfully submitted,



**LAWRENCE WILSON,
INTERIM DEPUTY TREASURER
for
DENISE L. NAPPIER, SECRETARY**

Reviewed by



**JOSEPH D. ROXE
CHAIRMAN**